No. 4048

United States Circuit Court of Appeals

For the Ninth Circuit

FIDELITY & DEPOSIT COMPANY OF MARYLAND, a Corporation,

Plaintiff in Error,

vs.

JOHN P. DUKE, Supervisor of Banking of the State of Washington, liquidating the KELSO STATE BANK,

Defendant in Error.

Upon Writ of Error to the United States District Court for the Western District of Washington, Southern Division.

HON. EDWARD E. CUSHMAN, *District Judge.*

Reply Brief of Defendant in Error

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Reply Brief of Defendant in Error

Plaintiff in Error has filed a reply brief, a written copy of which was handed to us at the opening of the oral argument and we had no opportunity of meeting the new matters until after the close of the oral argument and the service upon us of the printed brief.

We now ask permission to file a brief reply to the

new matters now urged for the first time by the plaintiff in error and not covered in the opening brief.

SET OFF

Counsel has again called the court's attention to *United States Fidelity & Guaranty Co. vs. Maxwell,* 237 S. W. Rep. 708, and has given that case a construction which we think the decision does not warrant. In this case the plaintiff had issued a policy of insurance to a bank covering the dishonesty of two employees of the bank. The two employees were guilty of fraud and the bank suffered a loss. The bank became insolvent and action was brought by the bank examiner upon these policies of insurance. At the time of the failure of the bank a depositor had on deposit in the bank a sum of money and held a policy of insurance issued by the same guaranty company to indemnify the depositor against loss; the guaranty company paid the loss of the depositor and took an assignment of the claim against the bank and filed it for allowance. In the action brought by the bank examiner the guaranty company undertook to off-set this claim against its liability upon the insurance covering the dishonesty of the employees of the bank and the Supreme Court of Arkansas held that it was not entitled to the off-set, and that was the question before the court.

We have quoted from this decision in our answer brief. The court held that

> "The right of set-off exists only to the extent of the concurrence of the two claims, and in case of insolvency proceedings under a statute prohibiting preferences the concurrence of claims must have existed before insolvency occurred and the proceedings were instituted . . . and that the right of subrogation carries with it the securities held by the original claimant, but this does not extend to the right to set off a claim which the party entitled to subrogation did not own prior to that time. If appellant be allowed to set off this claim the effect would be to give it a preference on a claim against the bank acquired subsequent to the time that the bank became insolvent and passed into the hands of the receiver."

Counsel has cited *Scott vs. Armstrong,* 146 U. S. 499. In this case a note was executed to a bank and the amount placed to the credit of the maker on the books of the bank. The maker of the note had no reason for thinking that the bank was insolvent, but the managing officer knew it to be insolvent. Before the note matured a receiver was appointed and the court held that the undrawn balance should be allowed as an equitable set-off to the note and that such an allowance would not constitute a preference.

Quoting from that decision:

> "The state of case where the claim sought to be off-set is acquired after the act of insolvency is far otherwise, for the rights of the parties become fixed as of that time, and to sustain such

a transfer would defeat the object of these provisions."

Quoting further from that decision:

"Indeed, natural justice would seem to require that where the transaction is such as to raise the presumption of an agreement for a set-off it should be held that the equity that this should be done is superior to any subsequent equity not arising out of a purchase for value without notice. In the case at bar the credits between the banks were reciprocal, and were parts of the same transaction, in which each corporation credited to the other on the faith of the simultaneous credit, and the principle applicable to mutual credits applied. It was, therefore, the balance upon the adjustment of the accounts which was the debt, and the Farmer's Bank had the right, as against the receiver of the Fidelity Bank, although the note matured after the suspension of the bank, to set off the balance due upon its deposit account, unless the provisions of the national banking law were to the contrary."

The court will notice that it is an entirely different case from the one now before the court. In the case cited the matter grew out of the same transaction, was concurrent and mutual; it did not involve the question of the trust funds involved in our case. In the case now before this court the claims are not mutual, not concurrent, and do not grow out of the same transaction; the sum due on the cashier's bond is a trust fund belonging to the depositors; it did not

belong to the bank at the time the receiver took charge; did not belong to the bank at the time the depositary bond was given to the county, for the bank was insolvent at that time and this was then a trust fund belonging to the depositors and cannot be off-set against a liability which the bank incurred thereafter in an indepedent matter.

This court will find a very recent decision of the Supreme Court of Washington of importance upon this question. The case is *Woods, Trustee in Bankruptcy, vs. Metropolitan National Bank,* decided September 19, 1923, reported in Vol. 26, No. 8, Washington Decisions, page 330. In this case a corporation became indebted to numerous parties and also gave the defendant bank some notes amounting to about $5500.00. The corporation was insolvent. After actual insolvency but before bankruptcy payments were made on the notes. The action was brought by the trustee in bankruptcy to recover from the bank the money paid on the notes while the corporation was actually insolvent. The court in passing on the question quotes from *Thompson vs. Huron Lbr. Co.,* 4 Wash., 600, which holds that:

> "Its property, on insolvency, becomes a trust fund for the benefit of all of its creditors to be equally and ratably distributed among them."

And, quoting from this recent decision:

> "But it is not our understanding of the trust fund doctrine that a bank, having possession of property of an insolvent corporation, acquired

> after the corporation becomes insolvent, has no greater right to sequester the fund of the satisfaction of an obligation to it than has the individual creditor of the corporation. The theory of that doctrine is that all of the assets of a corporation, immediately upon the insolvency of the corporation, become a trust fund for the benefit of all of its creditors, and that thereafter no liens or rights can be created, either voluntarily or by operation of law, whereby one creditor is given an advantage over others."

And the court held in this [illegible] the trustee in bankruptcy was entitled to recover money paid upon the notes for when the corporation became insolvent its property became a trust fund for the benefit of all of its creditors.

COMMON LAW BONDS

Counsel called the court's attention to *Smith vs. Tukwila,* 118 Wash. 266, and claim that this case is decisive of this question. So far as we are able to tell the case has little or no bearing upon the question. The court in that case was passing upon a contractor's bond. The bond had only one surety, did not comply with the law in that particular, and was not for the full amount of the contract price. The court held that it did not meet the requirements of the statute. The court says:

> "We take it that the statutes cited do not compel the municipality to execute the bond there

> provided for, but that it may elect to proceed with the work under other guarantees of its performance, taking the risk incident to failure to secure the statutory bond."

This decision is in line with other prior decisions of the Washington court to the effect that the failure of a municipality to take a bond renders the municipality liable. It may or may not take the bond; if it wants to escape liability itself it must exact a bond, otherwise it becomes responsible. The bond required to be given by bank officials is an entirely different matter. The bank officers are given no discretion but are required to take the bond, not only for the protection of the bank but for the protection of the depositors of the bank. It is obligatory and mandatory and there is no question of discretion about it.

In the case of *United States Fidelity & Guaranty Co. vs. Poetker,* L. R. A. 1917-B, 984, cited by us in our answer brief, the Supreme Court of Indiana in passing upon a statute similar to ours said:

> "It will be noted that while this statute leaves the amount of the bond to be fixed at the discretion of the board of directors, it is mandatory upon them to exact a bond from each of the officers named, and by its terms states the simple condition upon which it must be given in clear and unmistakable words; namely, that the officer will honestly and faithfully discharge his duties as such officer during his continuance in office."

There is a wide difference between the bond in

the *Smith-Tukwila* case and the bond in our case. In the Smith case the bond was not given by the number of sureties required by law; it did not comply with the requirements of the law; in our case the law requires a surety bond. A surety bond was given; while the amount was not previously fixed by the directors the bond was accepted and the amount thus ratified and fixed. The only difference is a slight change in the wording of the condition, as we have called to the court's attention in our answer brief; the meaning is the same, covers the same liability, and reaches the same purpose. We would call the court's attention to the fact that among the exhibits offered in evidence in this case the court will find that the banking officers who examined the bank from time to time reported to the state bank examiner that this bond was given and was in force; thus it was recognized by the state banking officers as a valid, existing bond.

KELSO FARM COMPANY NOTES

Counsel contend that the so-called resolution of the board of directors of January 11, 1921, did not refer to the $6,000.00 note given by Stewart to cover the Max Johnson paper. There is among the exhibits a letter from Marsh, one of the directors, dated a few days before this so-called resolution was passed, calling the directors' attention to this very matter, and while the note may have been dated previously

the entire record must convince the court that this was an attempt to ratify the giving of that note by Stewart. In the claim presented to the Guaranty Company this note was listed but not urged. There is nothing in the record to show that the resolution as passed was intended to cover loans made to the Kelso Farm Company; there is nothing to show that the directors had any knowledge that the Kelso Farm Company was Stewart's own company. It was formerly a corporation; it had been dissolved and the corporate name was continued; there is nothing to show that Stewart was authorized to take the money from the bank under an assumed name; there is nothing which connects this attempted authorization with this loan. But the attempted resolution was wholly without force and effect; it could not be an authorization to Stewart to take the money from the bank; the resolution not being passed as required by law cannot be given any force; it cannot have the effect of a ratification, for the law expressly provided that loans to an officer of a bank can be made only in the manner provided by law. At the time this pretended resolution was passed the bank was insolvent and Stewart knew it was insolvent and his withdrawing the funds from the bank at that time, even though authorized, was in violation of law and acquiescence by other directors could not give it force or effect.

In our answer brief we quoted from *State vs. Lindberg,* reported in Vol. 25, No. 1, Washington Decisions, p. 128, and we again want to call the

court's attention to this decision which holds that the law makes the borrowing officer guilty of a felony if the borrowing is in violation of the provisions of the act. One of the provisions of the act is that the borrowing officer must not be present when the resolution is passed. In this case the records show that when this attempted resolution was passed that Stewart was present. The court in the Lindberg case held that the crime was complete when the borrowing was consummated without a compliance with the statutory requirements, and in *State vs. Larson,* reported in Vol. 22, Wash. Dec., No. 10, page 471, cited by us, the court held that the mere fact that the transaction may take the form of a loan would not necessarily deprive it of its criminality. Quoting from that decision:

> "And that if such acts were consummated under the guise of a bona fide loan made with the assent of the other officers of the bank, such would not eliminate the criminality of the act and that the fraud itself might be inferred from the misappropriation of the funds."

There can be no question but what Stewart took the money from the bank in this instance fraudulently and with a guilty intent and design to misapply the same, for at that time he must have known of his own insolvent conditon and inability to repay the bank, and the insolvent condition of the bank.

It seems, therefore, clear that the embezzlement of

these funds by Stewart falls within the conditions of the bond.

Respectfully submitted,

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